Clientelism, Cronyism, and Job Creation in Lebanon

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4

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4.1 Introduction

This chapter, which is based on Diwan and Haidar (2017), looks into a country case where clientelism, rather than an attempt to exclude politically suspect firms from the marketplace, is likely to be the driving political force behind the tight relations connecting politicians and some firms. Our main interest is to evaluate the impact of clientelism on job creation. Paradoxically, while much of the discussion about clientelism in Lebanon concerns the influence of political patrons in helping secure jobs—public but also private—for their political clients, the country also has a very high emigration rate among its educated youth. In seeking to resolve this paradox, our core hypothesis is that clientelism in Lebanon may create extra jobs in particular firms, but that in the aggregate and on a net basis it destroys jobs.

After a review of the evolution of the state–business relationship in the recent political economy of Lebanon, we summarize the micro foundations of employment growth in Lebanon. Then, we document whether political connections affect job creation at the firm and sector levels. Depending on Diwan and Haidar (2017), we do so using a unique dataset which includes all registered (and thus formal) firms at the Lebanese Ministry of Finance which provides yearly information between 2005 and 2010 on firms' employment and output. We are able to identify among these firms a sub-group with political connections by comparing their characteristics with the firms identified in the Lebanese Commercial Register.

In the empirical section, we use Diwan and Haidar (2017) and start by highlighting facts about establishing new facts about patterns of job creation in Lebanon. Compared to other countries in the region, our results in Diwan and Haidar (2017) show that employment is more concentrated is much more concentrated in larger firms, although these larger firms do not exhibit better

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performance in terms of labor output per worker than smaller firms. However, once we look at the large firms that are not politically connected, the more usual pattern of larger firms having larger output per worker prevails. This suggests the possibility that politically connected firms (PCFs) are pushed to overhire among the clients of their political patrons in exchange for the economic privileges they receive. But a tight correlation between political connectedness and job creation does not prove causality. It is possible that successful business people tend to join the country's political elite, but that they do not receive particular economic privileges, and that overhiring by large firms is due to recent negative economic shocks together with labor market inflexibilities. We argue, using various pieces of evidence, including the 2009 parliamentary elections, that it is indeed political connections that have caused overhiring, and not the other way around.

In the second part of the chapter, we investigate the macro-economic implications of cronyism. We first emphasize that sectors that include firms with political connections create fewer jobs on a net basis than sectors that do not include PCFs. That unconnected firms create fewer jobs in sectors where connected firms operate is to be expected, since they are likely to shrink when connected firms expand. The interesting question, however, is whether, on a net basis, connected sectors end up as a whole growing less, and creating fewer jobs, than an otherwise similar but unconnected sector.

There are several possible explanations for the observed correlation between job creation and the existence of connected firms in the sector. One possibility relates to the fact that PCFs are likely to have more access to capital. If they produce in more capital-intensive ways, jobs will get destroyed in the sector when their market shares expand. A second possibility is that connected firms receive privileges mostly in sectors that are rent-rich and that have low growth potential. A third possibility is that unfair competition in connected sectors reduces economic activity by by lowering the incentives of both the industry leader and its (distant) followers to innovate—along the lines of the theses of Aghion et al. (2001, 2009). Using various pieces of evidence, including the circumstances observed during a highly competitive election in 2009, we argue that the competition hypothesis is most likely to be the best description of reality: that is, cronyism reduces economic growth.

The remainder of this chapter is organized as follows. In section 4.2 we present some salient points about the political economy of Lebanon, especially the centrality of clientelism and cronyism. We describe our firm-level dataset, identify PCFs, and establish stylized facts about connected and unconnected firms in section 4.3. We examine the impact of political connections on job creation, wages, output, and output per worker at the firm level in section 4.4., building up the argument that political connections cause job creation at the firm level in a competitive clientelistic political system such as that of Lebanon. In section 4.5 we focus on the sectoral implication of

political connections, and argue that unfair competition explains the lower growth of jobs in sectors that include PCFs. The concluding section summarizes our main findings and discusses possible policy implications.

4.2 Political Settlement and the Evolution of State–Business Relations in Lebanon

The consensual form of settlement that originated with the "national pact" reached between the two main camps of the time, during the pre-independence period, lives on—indeed, it has expanded to include the three major communities.[1] The Lebanese governance system has been described as a horizontal deal among communal oligarchs, supported by vertical organizations within each community (Diwan and Chaitani 2014).[2] These arrangements have involved various forms of accommodation and power sharing among groups, which have at time remained informal and at other times took the form of formal consensual institutions. While oligarchs have changed over time, the system itself survived devastating civil wars, endured extensive global and regional influences, and was also undeterred by the projection of power by many external forces.

A theoretical framework that captures many of these concerns is offered by North et al. (2013). North and colleagues emphasize how societies "limit violence through the manipulation of economic interests by the political system in order to create and distribute rents so that powerful groups and individuals find it in their interest to refrain from using violence" (North et al. 2009). In this analysis, national settlements involve deals between various groups that can improve their welfare by ensuring that the latent threat of violence is not exercised.

In applying such a framework to Lebanon, it is useful to focus on a situation with several sectarian groups, bargaining (horizontally) with each other to form a national coalition that monopolizes the use of violence, and within each group (vertically) to determine the relation between political elites ("oligarchs") and "citizens." Both horizontal and vertical deals involve restrictions

[1] While the post-independence republic was largely dominated by Christian groups, the Sunni group strengthened its position with the Ta'if agreement (1989) that ended the civil war, and the Shia group joined the settlement during the post-civil war period that started with the 1992 parliament.

[2] We recognize that identity is constructed. Ethnic differentiation in the Middle East was nurtured under the Ottoman Millet system for centuries (Ma'oz 1968). In Lebanon, it was further shaped by the Mutasarrifate of the Ottoman Empire (1861–1918), and by the ways in which the short colonial experience advantaged certain communities. More recently, political dynamics have played a role in the shaping of group identity through the instrumenting of religious discourse as a polarizing means to strengthen particular types of sectarian ideologies (Corm 2007).

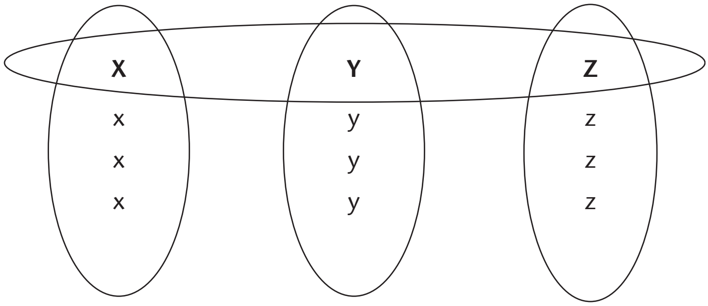


Figure 4.1. The dominant coalition of oligarchs.

on social organizations (economic, social, and political) in ways that create rents that can be used by oligarchs to support their rule (Figure 4.1). A "settlement" is a combination of horizontal and vertical arrangements that institutes peaceful relations by creating and distributing rents in such a way as to be superior among all players to a world with violence.

In Lebanon, the present consensual model of power sharing among sectarian groups was a legacy of Ottoman and French rule, but it has since been reconfigured several times as a result of changes in internal and external forces. A large and rich literature has sought to explain and delineate the variety of political settlements in Lebanon since the genesis of the Republic (Ajami 1986; El-Khazen 2003; Hakim 2013; Harris 1997; Kassir 1994; Traboulsi 2007; Ziadeh 2006). These phases included several types of coalitions: (1) small-size coalitions which delivered a stable macro-economic situation, but an unstable security environment, during the early "merchant republic" dominated by Christian elite interests (there was only a short period with a strong state that to some extent transcended communal oligarchs during the Shehab presidency); (2) large overstretched multi-group coalitions with high costs in terms of budget deficits, as during the current post-Ta'if agreement;[3] and (3) fragmented governance, as during the civil war of 1975–1990. The key characteristics of each phase/settlement included exclusionary political and economic mechanisms, the active pursuit of economic rents and their distribution, and the nature of the elite bargain. When examining the most recent period, four characteristics of the political settlement stand out in terms of their economic implications.

First, the trade-off between security and the economy, which was present in the various settlements, was especially constraining in the post-Ta'if (current)

[3] The Ta'if Agreement, also known as the National Reconciliation Accord or Document of National Accord, was an agreement reached in October 1989 to provide the basis for ending of the 1974–1989 Lebanese civil war and the return to political normalcy in Lebanon. The agreement was negotiated and signed in Ta'if, Saudi Arabia.

period. As the political settlement came to include in the 1990s the three main religious groups, fiscal and off-balance sheet spending had to rise as the overstretched coalition generated demands for large rents. The existence of rents to be distributed within groups conditions the survival of oligarchs, and, by implication, the stability of the whole political system. Indeed, the ability of oligarchs to make horizontal deals is, in large measure, dependent on the lack of the contestation within their community. Access to rents is primordial in order to develop clientelistic networks, a necessity for winning elections, and to deter alternative political forces from rising within the sectarian group. In the past, instances of reduced rents led to power shifts within communities, unbalancing horizontal agreements, and undermining the political order.[4] In the post-war reconstruction phase of the 1990s, it became necessary to build a large coalition of all influential political actors for ensuring security. This created the need for levels of rent generation and distribution unseen in recent Lebanese history, which was bound to become more costly from an economic perspective unless economic growth moved to a much higher level (due to security rents).[5]

Second, a large fiscal expansion, financed by debt, initially allowed the state, starting in the early 1990s, to be the main purveyor of clientelistic favors. All main groups engaged in hiring clients in the public sector, controlling funds for reconstruction, and providing preferential treatment in the procurement of government contracts to PCFs.[6] Government deficits were rarely below 20 percent of GDP since the mid-1990s, with a rising part of spending made up of interest payments on public debt. As the fiscal space closed down, a multitude of off-balance sheet cost-centers arose, and these centers were divided among the various oligarchic networks.[7] These high levels of public

[4] Some of the change can be attributed to external actors, which affected power relations between as well as within communities, in some cases adding to rents in the system (as with the generous GCC financing of the post-civil war reconstruction, or Iran's financing of political groups within different communities in Lebanon) and in other cases influencing the ability of groups to extract rents from the system.

[5] Different types of rents can differ in the extent to which they supported economic growth (rents from cooperation) versus the extent to which they taxed growth (external rents that generate political divisions, regulatory rents that tax the economy). The first type relates to the conditions of security that allowed Lebanon, at the time, to become a touristic, entrepôt, and banking center in a troubled region. The second relates to the use of state-provided patrimonial instruments (such as state employment, controls over various funds, and choice of infrastructure investments), economic distortions, and related rents (such as access to contracts and the way in which the policy framework benefits particular groups).

[6] The distribution of state favors in the post-war period neglected redistribution to the poorest in favor of equal shares to the different communities. Indeed, group composition and share of public spending are strikingly equal, with the distribution of public capital expenditure (1996–2005) closely related to the distribution of registered voters (Salti and Chaaban 2010).

[7] For example, the Council of Development and Reconstruction (CDR) was run by the Sunni group; the Council of the South was under the suzerainty of the Shia group; the energy industry (and its lucrative import of oil) was under the jurisdiction of the Maronite group; and the Ministries

expenditures were possibly predicated on fast economic growth, as happened in the first part of the 1990s. But with the demise of the Israeli–Palestinian peace process, the regional outlook deteriorated substantially, and growth rates came to a halt in the second part of the decade. As a result, large state expenditures became unsustainable, resulting in a ballooning public debt that reached 300 percent of GDP by the end of the decade. Given the lack of fiscal space, oligarchs had to look elsewhere to finance their clientelistic endeavors, turning increasingly toward financiers from abroad (Iran, the Gulf Cooperation Council (GCC), the West), and increasingly engaging in the extraction of regulatory rents from the domestic private sector.[8]

Third, Lebanon has a weak state. Political scientists have stressed how the political economy of Lebanon has militated for a weak state, as a defensive mechanism by the various religious groups to retain some autonomy (Salibi 1990). Three implications arise. First, the narrow range of functions controlled by the state limit how much regulatory rents can be extracted by dispensing privileges. Second, discretionary policies can be used more as carrot than stick. In contrast, Egypt and Tunisia were dominated until 2011 by autocrats who remained in power for over 30 years, using a system rich in sticks. As a result, the political means for developing crony relations in Lebanon can be located more in the provision of privileges than in economic exclusion, unlike Tunisia and Egypt where the exclusion motive was dominant. Such a system requires large privileges in a narrow set of sectors, and is thus potentially quite costly in terms of growth in sectors under state influence. Third, since, overall, the potential for rent extraction is limited, it is therefore difficult to sustain a large coalition without sizable external support.

The systematic allocation of privileges to connected businessmen along sectarian lines (the system of *Muhasasa*) has made Lebanon, in the eyes of the Lebanese, one of the most corrupt countries in the Arab region. For example, the World Bank Enterprise Survey (2013) shows that three-fifths of Lebanese firms identify corruption as a major constraint for their growth. Similarly, the Gallup (2011) surveys show that the Lebanese public views corruption in the public and private sectors more negatively than in other countries of the Middle East (Figure 4.2).

Fourth, and especially after 2005, there was greater intergroup competition due to the growing regional rift between Iran and Saudi Arabia (and later, the

of the Displaced, Public Works, and Health were usually assigned to the Druze group (Leenders 2012).

[8] In contrast, the more restricted coalitions of the 1960s allowed for a large degree of macro stability that oversaw some of the fastest rates of economic growth of the region. However, the narrow socio-economic coalition could not stem the rise of groups that felt excluded, and the country burst increasingly into cycles of grievances and violence that ultimately led to the civil war.

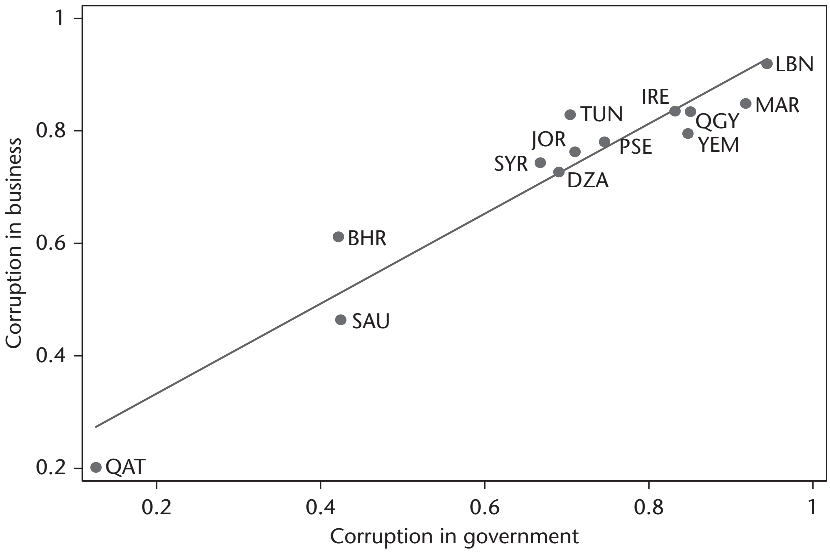


Figure 4.2. Perceptions of corruption in government and business (2010).
Source: Gallup 2011

divisive effects of the Syrian crisis). This fact weakened the oligarchic settlement, and created more intergroup and intragroup competition. As a result, the parliamentary elections of 2009 were extremely competitive. These elections pitted the two broad political coalitions of March 14 and March 8 movements against each other for the second time after the 2005 elections. They took place under an electoral law that was free from the Syrian gerrymandering of the post-civil war period. The law was adopted following violent armed clashes that took place in Beirut in early May 2008. In the peace talks that followed (the Doha peace negotiations), the Lebanese politicians designed a new electoral law under whose ambit elections were held on June 7, 2009. The new law favored competition, and it used small electoral units and a majoritarian first-pass-the-post system. This law was based on 26 districts, like the electoral law of 1960, but unlike all elections held after 1989.

4.3 The Corporate Landscape

In this section, we describe the corporate dataset that we use in Diwan and Haidar (2017), before identifying a set of PCFs. We then go on to contrast their corporate characteristics (job creation, output per worker, wage bill) with those of unconnected firms.

4.3.1 *Firm-Level Data*

We employ data on tax-paying firms, which we obtained from the Lebanese Ministry of Finance (MoF) via the United Nations Economic and Social Commission for Western Asia (UN-ESCWA). The dataset includes all registered firms at the Directorate of Revenues, and provides annual information between 2005 and 2010.[9] While our dataset does not contain all the existing information about each firm, it includes data about each firm's date of birth, 4-digit sector of business operation, number of employees, wages per year, and sales. This dataset has several advantages for the purposes of this study. First, its complete coverage of all firms and sectors on an annual basis allows us to compare performance within and across firms and sectors in a comprehensive manner. Second, the data cover all registered firms, with no size threshold, capturing the universe rather than a sample of firms in Lebanon. Over the sample period of 2005–2010 that we study, the database includes information about 120,000 firms on average per year. Third, the dataset includes information on each firm's output and number of employees, which allows us to look not just at job creation, but also at output per employee at the firm level and across sectors.[10] Fourth, we are able to observe when particular firms enter or exit the economy, and thus can track the entry and exit of firms from various sectors. The dataset only covers formal firms and formal workers—the latter constitute an estimated 60 percent of the employed population in Lebanon (there were an estimated 613,000 additional informal workers working mainly in micro enterprises in 2010, according to the International Labor Organization (ILO). Nevertheless, it covers a large share of formal jobs. For example, in 2010, firms in our database report employing 775,540 workers while, according to the ILO (2015), the number of workers in the formal sector in 2010 was 777,000.

4.3.2 *Stylized Facts—All Firms*

Analysis of the relationship between firm size and employment in Lebanon has been hampered to date by data limitations. The dataset from the MoF allows us in Diwan and Haidar (2017) to characterize a set of surprising, and to our knowledge relatively unknown, stylized facts on the distribution of jobs, old and new, among firms of different size and age.

It turns out that a specificity of Lebanon is that a large share of labor works in relatively large firms, unlike the pattern typically observed in developing

[9] All included firms are registered at the Commercial Register and with the National Social Security Fund (NSSF).

[10] However, the data do not include information about profitability.

economies, where private-sector jobs tend to be clustered around a vast abundance of small firms, and only a handful of substantially large ones.[11] Table 4.1 shows that over the period 2005–2010, large firms that employ 100 or more employees account for nearly half of total (formal) employment in Lebanon. This figure is very large by regional standards: Small-scale activities provide the majority of jobs in the Middle East and North Africa (MENA) region. In Turkey, Tunisia, and Jordan, for example, only 20–30 percent of labor works in large firms, while in Egypt, and in the West Bank and Gaza, this figure is below 10 percent.[12] This share is not explained by a lack of small firms: 87 percent of firms have fewer than five employees in Lebanon. Moreover, there is a trend toward larger size: From 2005 to 2010, the share of jobs in micro firms declined from 15.2 percent to 13 percent, while it increased in large firms from 41.1 percent to 47.8 percent (Table 4.1).

More importantly, large firms have driven net job creation in the recent past. Figure 4.3 shows net job creation in each year by firms of different size categories. In any given year between 2006 and 2010, the bulk of net job creation was in larger firms. A closer look at the data in Table 4.2 shows that in most years, self-employed micro firms were actually responsible for the destruction of jobs, in net terms.[13] For example, in 2010, firms that employed at least 200 employees created 22,511 jobs, while micro firms destroyed 3,074 jobs. Setting aside self-employed firms, these large firms accounted for 55 percent of net job creation. In contrast, more than 90 percent of the new jobs created in Tunisia and Egypt in the late 1990s and 2000s came from small firms (World Bank 2014, pp. 24–27).

It is noteworthy that when it comes to job creation, it is the formal firms in our dataset, as opposed to the informal sector, that have been the main creators of new jobs in recent years. According to the ILO (2015), about 56,000 workers enter the market each year. Firms in our database create between 40,000 and 50,000 new (formal) jobs per year, which is between 70 and 90 percent of all jobs created (Table 4.2 and Figure 4.4). Thus, between 2005 and 2010, large firms have created most of the new jobs in Lebanon, even when the informal sector is considered. Overall, the relatively large share of employment and job creation in large firms in Lebanon is intriguing and unique in the Middle East, and so it begs for a convincing explanation.

[11] For evidence see Ayyagari et al. (2014), and for more discussion see World Bank (2016).

[12] For details see Figure 1.5 in World Bank (2014).

[13] This contradicts the report of the World Bank (2014), which claims that most new jobs in Lebanon during the period were created by micro firms. The World Bank report uses the same data as we do, but it turns out that it mistakenly coded all employment in micro firms in 2006 as *new* jobs.

Table 4.1. Firm size and employment distributions

Number of employees	2005	2006	2007	2008	2009	2010	2005	2006	2007	2008	2009	2010
	Share of firms (%)						Share of jobs					
1[1]	76.1	76.1	76.3	76.4	76.5	76.7	15.2	14.6	13.9	13.4	13.2	13.0
2	5.1	4.8	4.6	4.5	4.4	4.5	2.0	1.9	1.7	1.6	1.5	1.5
3	3.8	3.7	3.5	3.5	3.4	3.4	2.3	2.1	1.9	1.8	1.8	1.7
4	2.8	2.8	2.7	2.7	2.6	2.6	2.2	2.2	2.0	1.9	1.8	1.8
5	1.9	1.9	1.9	1.9	1.9	1.8	1.9	1.8	1.7	1.7	1.6	1.6
6–9	4.0	4.0	4.1	4.1	4.1	4.1	5.8	5.6	5.4	5.2	5.1	5.0
10–19	3.0	3.1	3.2	3.3	3.3	3.2	8.1	8.0	7.8	7.7	7.5	7.3
20–49	1.9	2.0	2.1	2.1	2.2	2.1	11.5	11.5	11.4	11.4	11.2	11.0
50–99	0.7	0.7	0.8	0.8	0.8	0.8	9.8	9.7	9.5	9.4	9.5	9.2
100–199	0.3	0.4	0.4	0.4	0.4	0.4	9.7	9.5	10.	9.7	9.5	9.4
200–999	0.3	0.3	0.3	0.3	0.3	0.3	21.3	22.0	22.4	22.1	22.5	22.6
>= 1000	0.03	0.03	0.03	0.04	0.04	0.04	10.1	11.2	12.2	14.2	14.7	15.8

[1] Self-employed firms. The average number of firms and jobs per year between 2005 and 2010 is 122,237 and 677,812, respectively.

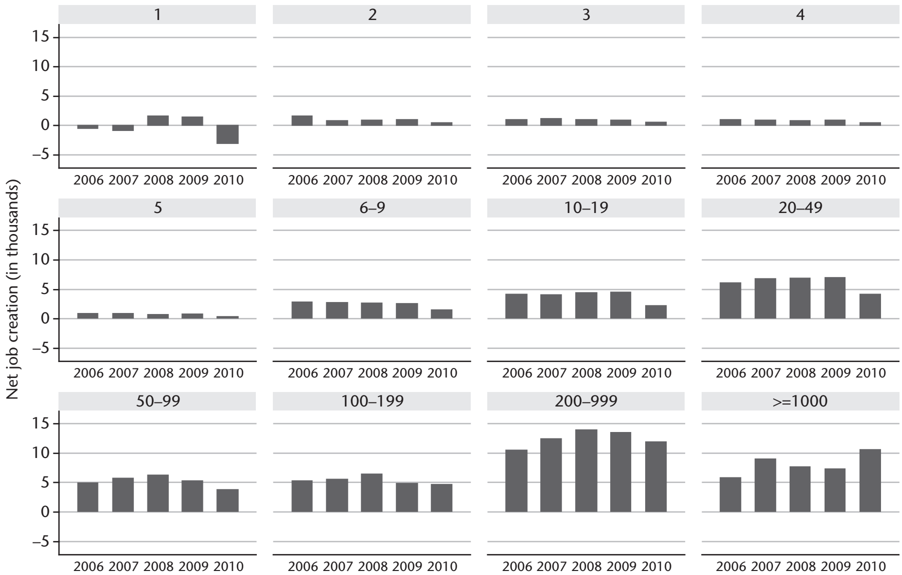


Figure 4.3. Net job creation by firm size in Lebanon (2006–2010).
Source: Authors' calculations using MoF dataset

4.3.3 *Politically Connected Firms*

As discussed in more detail in Diwan and Haidar (2017), we aim to assess the stylized facts described above are related to the role played in the Lebanese economy by PCFs. To do this, we start by determining which firms in our database are politically connected, which is a challenging task. It requires assembling lists of politicians and of businessmen closely connected to them, and then determining systematically over the universe of all firms whether any of these individuals has a relation with any of the firms we have information on. To make the (manual) search easier we restricted our search to the 2000 firms of more than 50 employees. In this manner, we identified 497 PCFs in our MoF dataset by following a three-step procedure.

First, we developed a long list of political actors to ensure we covered all parties that were involved in the post-Ta'if political settlement (as described in section 4.2). We defined a person to be politically connected as follows: (1) if she/he is a member of parliament, minister, or president who has been in office between 1992 and 2010; (2) all direct family members (i.e., father, mother, brother, sister, spouse, son, or daughter) of this group; or (3) publicly known friends of this group.[14] The inclusion of people that were in power in

[14] Our method of identifying PCFs is closely related to Chekir and Diwan (2015), Diwan et al. (2015), Faccio (2007), and Rijkers et al. (2017a).

Table 4.2. Net job creation by firm size

Number of employees	2006	2007	2008	2009	2010	2006	2007	2008	2009	2010
	Net number of firms that created jobs					Net jobs created				
1[1]	–2917	–3524	–2513	–3010	–6830	–459	–870	1610	1455	–3074
2	592	457	434	473	272	1612	798	886	1058	478
3	590	552	533	533	293	1021	1235	1016	953	594
4	461	518	495	467	244	1042	926	802	932	449
5	391	442	434	451	202	928	899	753	852	403
6–9	1254	1248	1283	1187	623	2804	2784	2708	2594	1478
10–19	1342	1386	1498	1451	829	4165	4098	4431	4531	2259
20–49	1211	1273	1385	1384	952	6077	6803	6872	7014	4212
50–99	505	561	616	621	484	4958	5764	6244	5280	3779
100–199	277	317	342	327	312	5299	5594	6466	4852	4643
200–999	233	264	282	313	290	10,543	12,396	13,935	13,535	11,902
>= 1000	25	30	35	43	49	5838	8956	7639	7302	10,609
Total	3964	3524	4824	4240	–2280	43,828	49,383	53,362	50,358	37,732

[1] Self-employed firms.

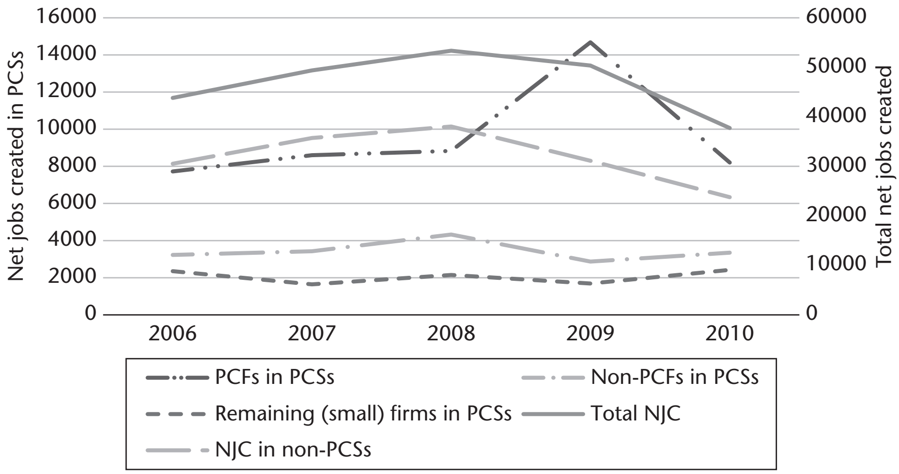


Figure 4.4. Aggregate net job creation (NJC) in Lebanon. PCS, Politically connected sector.
Source: Authors' calculations using MoF dataset

previous administrations allows us to capture more firms that may have benefited from political connections in later years, and is valid because the same oligarchy has been in power since the end of the civil war in 1989 (Traboulsi 2007).

Second, we used the Commercial Register at the Ministry of Justice to identify PCFs. The Commercial Register includes information on all "formal" firms registered in Lebanon. It includes for each firm several variables: the names of owners and founders of the firm, board members and managers, paid in capital, date of birth, and sector of operation. We searched throughout the registry for all firms with at least 50 employees in at least one year between 2005 and 2010 that included at least one name—partial owner, founder, shareholder, or officer—that is also on our list of political actors.[15] This procedure allowed us to identify 497 PCFs (of which 228 are connected solely through family members or friends of politicians, and the others are connected directly through politicians themselves).

Third, we matched all the PCFs that we found in the Commercial Register with the MoF dataset. While our MoF dataset does not include names of firms, it includes each firm's date of birth and sector of activity. In all cases, we

[15] At this stage, we did not look into the issue of PCFs owning other firms—we intend to enrich our dataset with such measures in the future. We would also consider including firms that were revealed in the Panama and Paradise Islands papers as belonging to Lebanese individuals that are politically connected. Some of these firms may be shareholders of some Lebanese firms.

looked to see whether the date of birth and sector characteristic of a firm in our database matched uniquely with a firm in the Commercial Register, allowing us to deduce the name of the PCFs that we wanted to identify. This procedure puts us in a position to compare the corporate characteristics of connected and unconnected firms in the MoF dataset.

It is clear that we could not hope to capture all the PCFs in Lebanon with our procedure. Instead, our aim has been to capture as much of the "top of the pyramid" as possible. While our procedure is likely to miss some of the existing large PCFs, it is unlikely that we erroneously characterize firms as a PCF. Also, it is likely to provide downward-biased estimates, allowing us to claim that we underestimate the effects of political connections in the empirical analysis below.

We mention here a few examples from the TV sector to clarify our approach. Future TV is owned by the sons, wife, brother, sister, and other friends of Rafic Hariri. The latter was a prime minister in Lebanon several times between 1992 and 2005. His sister has been a member of Lebanese parliament since 1992; his son has been a member of parliament since 2005 and served as prime minister too during the time span of our dataset. Thus, we coded Future TV as politically connected. Al-Manar TV is well known to be the mouthpiece of Hizbullah, a political party in Lebanon. Even though the Commercial Register does not include names of owners or shareholders of Al-Manar TV, we still coded Al-Manar TV as politically connected given that it is publicly known to be dominated by a political party. We also coded the NBN TV channel as a PCF because several of its owners, who are listed on the Commercial Register, are on our list of political figures (i.e., Yassin Jaber and Nehme Tohme). Where none of the owners or managers of a given firm is on our list of politically connected individuals, nor clearly affiliated with a party, we did not code the firm as politically connected. For example, in the TV sector, we coded LBC TV and Al-Jadeed TV as unconnected firms. In other words, we do not consider the political preference of firm owners as a proxy for their political connectedness.

The 497 PCFs that we identified are mainly concentrated in the banking, media, energy (including oil and gas distribution), health (i.e., hospitals, drug import and distribution), real-estate construction, road paving, water extraction and sale, mining (including quarries), telecommunications, soft drinks, and pharmaceutical production sectors. Together, they operate in only 29 of the 289 (4-digit) sectors that exist in Lebanon.[16] Although some PCFs may be monopolizing particular national or sub-national markets (e.g., import of pharmaceutical products, or quarries), their large number in other sectors suggests that they may also compete against each other in particular sectors.

[16] All the sectors identified by Leenders (2012) are captured by our methodology to identify PCFs. It is noteworthy that nearly all sectors belong to the non-tradable group.

An important difference between Lebanese and Egyptian or Tunisian cronyism, two countries that have been studied in some detail, is that the sectors of activity of PCFs in Lebanon are narrower. In Egypt, Diwan et al. (2015) found that PCFs were operating in 174 4-digit sectors, out of a total 350 sectors of operation. In Tunisia too, the connected sectors were found to be widespread—present in 30 of the 32 2-digit sectors of the economy (Rijkers et al. 2017b). In both countries, research has shown that rents were created by systematic policy changes that instituted systems of industrial subsidies (mainly cheap fuel), by closing off international competition through the imposition of non-tariff barriers, or by erecting barriers to foreign investors by closing off entire sectors to foreign firms (Eibl and Malik 2016; Rijkers et al. 2017a).[17] In Lebanon, as suggested in our discussion in section 4.2, weaker governments could not make and implement such ambitious state interventions. Instead, rents exist only in sectors of more traditional state influence, such as the application of zoning laws, the regulation of schools and hospitals, or the control over government procurement.

Table 4.3 presents the distribution of PCFs in Lebanon and summarizes some of their key characteristics, comparing them with non-politically connected firms (non-PCFs) in their sectors of activity. We focus on firms that had 50 employees at least once during the period, in order to compare firms of the same size category. Overall, PCFs represent 42.7 percent of all the large firms in Lebanon (of over 100 workers) and 72 percent of the large firms in the sectors in which they operate. PCFs tend to be larger than their unconnected direct-sector competitors. On average, each PCF employs 225 workers, compared to an average of 90 employees in non-PCFs (in the connected 29 sectors—see Table 4.3). As a group, the PCFs employ over 123,000 employees, which is about 16 percent of the labor force in the formal sector.

One can also observe in Table 4.3 that, on average, PCFs employed more workers per unit of output produced than non-PCFs. In other words, they had a lower output per worker ratio than non-PCFs in 26 of the 29 sectors in which they operate (and especially so in the banking, gas distribution, and pharmaceutical sectors). The fact that larger firms have lower output per worker stands in contrast to the experience of fast-growing economies, such as Turkey and the USA, where larger firms tend to have higher productivity (Atiyas and Bakis 2015; Haltiwanger et al. 2013).

In section 4.4, we ask whether these characteristics of the labor market may be related to the distinctive political system in Lebanon that combines clientelism and cronyism.

[17] Some of these studies have also shown that policy change followed the entry of PCFs in particular sectors. In the case of Lebanon, the time series we have is too limited to look carefully at the timing of the entry of cronies in particular sectors, which in most cases pre-dates 2005.

Table 4.3. Characteristics of PCFs and non-PCFs in Lebanon

Sector	PCFs					Non-PCFs				
	Number of firms	Number of workers per firm	Output per worker	Wage per worker	Age (years)	Number of firms	Number of workers per firm	Output per worker	Wage per worker	Age (years)
Real-estate development	103	247	155	15	10	51	48	181	12	13
Private contractors of public works	54	79	53	15	11	18	55	73	9	15
Hotels	34	80	100	14	8	22	52	82	9	9
Commercial banks	31	793	312	40	28	28	421	380	24	26
Private schools	28	619	39	14	18	118	111	42	10	23
Security companies	23	711	16	13	6	5	86	19	9	9
Building cleaning services	22	145	22	10	8	12	62	33	9	11
Waterfront resorts	21	229	17	10	8	17	48	27	8	10
Business and management consulting	17	72	23	12	8	23	51	28	9	11
Shipping lines	17	53	93	12	11	4	65	69	9	8
Financial intermediaries	15	39	162	16	11	10	56	171	12	13
Quarries	14	74	57	10	10	42	46	65	8	15
Telecommunications companies	14	65	68	11	12	16	48	74	9	14
Insurance companies	13	130	43	28	11	19	80	51	15	16
Garbage collection companies	11	315	21	10	9	8	91	28	9	10
Print houses	9	47	141	15	10	39	82	73	8	10
Domestic transportation companies	9	144	18	11	10	43	45	28	8	16
Hospitals	8	321	28	36	19	100	123	39	23	25
Mineral water production	7	167	47	12	10	8	63	61	8	12
Private universities	7	619	56	32	8	21	212	82	20	9
Sport centers	6	93	59	13	5	3	41	79	8	6
Gas distributors	4	146	347	12	11	3	52	378	9	13
Soft-drinks production	4	302	155	15	19	2	87	173	9	15
Dairy products manufacturing	4	157	200	9	13	8	61	229	6	16
Electrical equipment manufacturing	3	52	45	9	11	2	69	51	7	14
Importers and producers of pharmaceuticals	2	180	322	15	12	6	59	361	9	9
Newspaper and magazine production	4	166	62	15	30	3	80	84	9	18
Radio and TV production	11	363	71	18	13	5	231	85	9	10
Advertising companies	2	103	92	19	10	3	73	101	10	12
Total	497					639				

Output per worker, wage per worker, and capital are in LBP million. Figures represent annual averages at the firm level. Table includes only firms with at least 50 employees in any year between 2005 and 2010 in politically connected sectors (PCSs). None of the remaining (2237) firms in PCSs had 50 employees in any year between 2005 and 2010.

4.4 Jobs for Votes?

We have observed that, on average, PCFs grow more and produce more jobs than the non-PCFs within their sector of activity. Our contention is that PCFs create more jobs than non-PCFs as a way of returning favors to politicians. But there are two other possible explanations that are consistent with these stylized patterns. In this section, we contrast these three possibilities and argue that our preferred hypothesis is the most likely to be valid one.

- The first hypothesis (call it H1) is that PCFs are simply successful firms, and that as a result of innovations, superior skills, and more productive effort, they were able to beat their competitors, increase their market share, and thus expand production and employment. These entrepreneurs tend to become politically connected once they grow and become large employers. This would be the case when successful businessmen become politicians, or get close to them because of their national importance, but these firms do not receive special privileges from the state.
- A second related hypothesis (H2) considers the possibility that after a period of growth, PCFs were hit by a negative economic shock, but that due to inflexibilities in the formal labor market, they were not able to adjust their employment levels, and thus ended up overstaffed.
- The third hypothesis (H3) is that PCFs are pushed to overhire by politicians as a repayment for the favors they bestow on them.

We are limited in our ability to test H3 directly, since this would have to involve some structured fieldwork directed at the employees of these companies and their unconnected competitors. Our identification strategy will instead take advantage of the data we have to construct an indirect proof that argues that: (1) the data contradict some of H1 and H2's implications on corporate behavior; (s) the data support the implications of H3 regarding the PCFs' and non-PCFs' corporate and employment behavior; and (3) H3 is a reasonable statement in the context of the political economy of Lebanon.

The three hypotheses have different implications for the effects of political connectedness on firms: how many jobs they create, the level of their sales, the wages they pay, and their output per worker. Under H1, all firms—PCFs and non-PCFs—maximize profits and hire labor as long as their marginal cost of labor is equal to their marginal benefit of expanding. Under H2, however, we expect that PCFs would have lower output per labor than non-PCFs. Under H3, we expect that the privileges PCFs receive allow them to reduce their operating costs, giving them an advantage over their competitors. As a result, they will end up at their optimum with larger market shares than their unconnected competitors, and with larger profits. At the same time, because

politicians in our model bestow privileges on condition that they hire some of their clients, we would expect PCFs' decisions to depart from their first best optimum, and that they would spend part of their profit on hiring more workers than implied by pure profit maximization (how much would depend on the relative bargaining powers of PCFs and their political patrons). Thus, under H3, we would expect to find that PCFs hire more workers than otherwise similar non-PCFs in their sectors, and end up with lower levels of output per worker. By the same token, we would expect that the presence of more PCFs in a sector could increase competition among the PCFs, reducing their profits, and thus restricting their ability to serve political interests. Thus, under H3, we would expect that the PCF bias would be smaller in sectors with more PCFs. Finally, under H3, we would expect PCFs to increase their hiring and end up with lower output per worker just before election time. In sections 4.4.1, 4.4.2, and 4.4.3, we consider the summary statistics results from more formal regression analysis that controls for other factors—for further details, see the technical work-in-progress paper, Diwan and Haidar (2017).[18]

4.4.1 *Successful Firms Becoming Politically Connected?*

There are three reasons to reject H1. First, regression analysis in Diwan and Haidar (2017) confirms that PCFs create more jobs, but have lower output per worker than comparable non-PCFs. More precisely, we found that PCFs create 20.32 percent more jobs each year on average than unconnected firms that operate within their same sector (controlling for PCF size and age, and the number of PCFs in the sector). We also found that in PCFs, output per employee is 20.38 percent lower than in non-PCFs. These magnitudes are large.[19] For H1 to be consistent with the fact that PCFs are more labor intensive than non-PCFs, it must be the case that either non-PCFs have privileged access to capital, or that PCFs have very little access to capital and are successful in spite of this constraint. The reality is, however, completely different. While our dataset does not include data on different types of capital, it shows that PCFs tend to have higher initial paid-in capital than non-PCFs (Table 4.3).

[18] The results we report from regression analysis come from a set-up where we estimate a simple linear model where the dependent variable represents, in different estimations, net job creation, average wage per employee, output, and output per employee at the firm-year level. The independent variables are a dummy variable equal to 1 if the firm is politically connected, and zero otherwise; a dummy variable equal to 1 in year 2009, and zero otherwise; controls for firm size (in terms of number of employees) and age; the number of PCFs at the sector-year level; 2-digit sector fixed effects; and a year dummy. We restricted the analysis to all 4-digit sectors with at least 10 percent of the firms having at least 50 employees in at least one year between 2005 and 2010.

[19] Moreover, the differential effects of age and size are informative: Older and large firms are associated with more net job creation, and more so if they are PCFs. However, older and larger PCFs are associated with even lower output per worker, suggesting that overstaffing increases over time.

A second test of H1 is to look at the type of employer–employee relations. If (some of) the workers employed by PCFs (but not of non-PCFs) are politically connected, they should be able to exert more pressure on firms to receive higher wages. In the H1 story, however, there would be no reason to expect good businessmen to offer higher wages, especially if their workers are less productive. Thus, we expect PCFs to offer higher wages than their unconnected competitors under H3, but not under H1. Table 4.3 suggests that workers in PCFs do indeed receive higher wages, on average, than workers in non-PCFs.[20] Regression results in Diwan and Haidar (2017) confirm that PCFs pay higher wages to their employees than comparable non-PCFs—that is, in their same sector of activity and of similar age and size—paying 16.29 percent higher wage per employee (although, as stated above, output per employee is 20.38 percent lower).

Therefore, the evidence discussed in this section suggests that we can convincingly reject the first hypothesis (H1) that PCFs are simply successful firms, and that as a result of innovations, superior skills, and more productive effort, they were able to beat their competitors, increase their market share, and thus expand production and employment.

4.4.2 *Negative Economic Shocks*

The main argument that we have for rejecting H2 is the differential performance of PCFs and non-PCFs around the parliamentary elections of 2009. Under H2, elections should affect all firms in the same manner—negatively, if they generate uncertainty, or positively if they usher a more attractive future. Under H3, elections should generate more pressures for job creation among PCFs as a way to secure votes. The two questions to address thus are: did the PCFs hire more than non-PCFs just before the 2009 elections? And, if yes, was there a negative economic shock around 2008, which could explain PCF overstaffing levels in 2009?

On the face of it, an election effect seems apparent at the macro level. Figure 4.4, which comes from Diwan and Haidar (2017) shows that in 2009, the overall hiring by PCFs jumped from an average of 8,000 new jobs per year over the 5-year period, to 14,500, at a time when the unconnected firms in the same 29 sectors reduced their hiring (from an average of 6,000 a year, to about 4,000). At the same time, public-sector recruitment also rose from 3300 in 2008 to 5941 in 2009 (but then dropped to 762 in 2010—see Table 2.1 in Abou Jaoude 2015). Regression analysis in Diwan and Haidar (2017) confirms that the effect of political connectedness became larger in 2009, with

[20] The Lebanon case turns out to be somewhat similar to that of France. Bertrand et al. (2007) show how firms managed by politically connected CEOs in France create more jobs in the politically more contested areas (and especially so around election years), and receive in exchange privileged access to subsidy programs.

hiring by PCFs rising by an extra 25.4 percent. Moreover, there is a large additional deterioration in PCFs' output per worker in 2009 (of 23.3 percent).

Was there a negative economic shock around 2008 that could explain why high-growth firms may have found themselves to be overstaffed in 2009? Economic data do not support such a possibility. The Lebanese economy grew at a moderate speed during the first half of the 2000s, averaging 2.5 percent a year during the period, with a peak of 5.9 percent in 2004 and a low of 1.6 percent in 2006, a period of political crisis. Growth rate accelerated in the second half of the decade, at 9.5 percent in 2007, 9.1 percent in 2008, 10.3 percent in 2009, and 8 percent in 2010 (growth collapsed afterwards and oscillated between 1 and 2 percent between 2011 and 2016). Thus, there was no noticeable growth shock that could have trigged overstaffing by fast-growing firms, including PCFs, during our period of study, and certainly not around the election of 2009.

Thus, on the basis of the empirical regularities we observe, we can reject the second hypothesis (H2) which considers the possibility that after a period of growth, PCFs were hit by a negative economic shock, but that due to inflexibilities in the formal labor market, they were not able to adjust their employment levels, and thus ended up overstaffed.

4.4.3 *Evidence Backing Political Clientelism*

We end by noting that the third hypothesis (H3), which is that PCFs are pushed to overhire by politicians as a repayment for the favors they bestow on them, is coherent in more than one way with the popular narrative of the type of political clientelism that characterizes the Lebanese political economy.

First, we know from journalistic investigations (Ibrahim and Saoud 2015) and the anthropological work of Leenders (2012) that many PCFs received special advantages. These studies have identified and documented mechanisms through which privileges are provided—for example, by constraining the hiring practices of the contractors of official agencies (e.g., the electricity utility, the Beirut port), by applying regulatory rules in a discriminatory fashion (e.g., health or construction regulations), or by providing prime land to and allowing the operations of illegal quarries by PCFs. Particular sectors where corrupt deals have been covered by the media include pharmaceuticals (which are affected by both state regulation and procurement), quarries (which are affected by licensing and environmental regulations), construction (which is deeply affected by state procurement, and especially by the Council of Development and Reconstruction), oil and gas (state regulation), fuel import (state procurement), and garbage disposal (state procurement plus monopoly power).

Second, local narratives confirm that political clientelism in Lebanon is based on the provision of various types of services in exchange for votes,

including employment in both the public and private sectors. This belief is apparent in opinion polls. For example, three-quarters of university students surveyed by the Lebanese Centre for Policy Studies thought that political connections were important to finding jobs, and 20 percent said they had, in fact, used them (LCPS 2013). Moreover, in an Arab Barometer poll (2014), nearly 80 percent of respondents in Lebanon said they strongly believe jobs are largely obtained on the basis of *wasta*, an Arabic term to describe a favor—and this was the highest score in the Arab world (Figure 4.5).

A final consideration relates to the rising competition among PCFs. More competition reduces the value of privileges, and thus the PCF's advantage. This should result in a smaller productivity differential between PCFs and non-PCFs. Regression analysis in Diwan and Haidar (2017) shows that this is indeed the case: The presence of more PCFs in a sector affects the behavior of

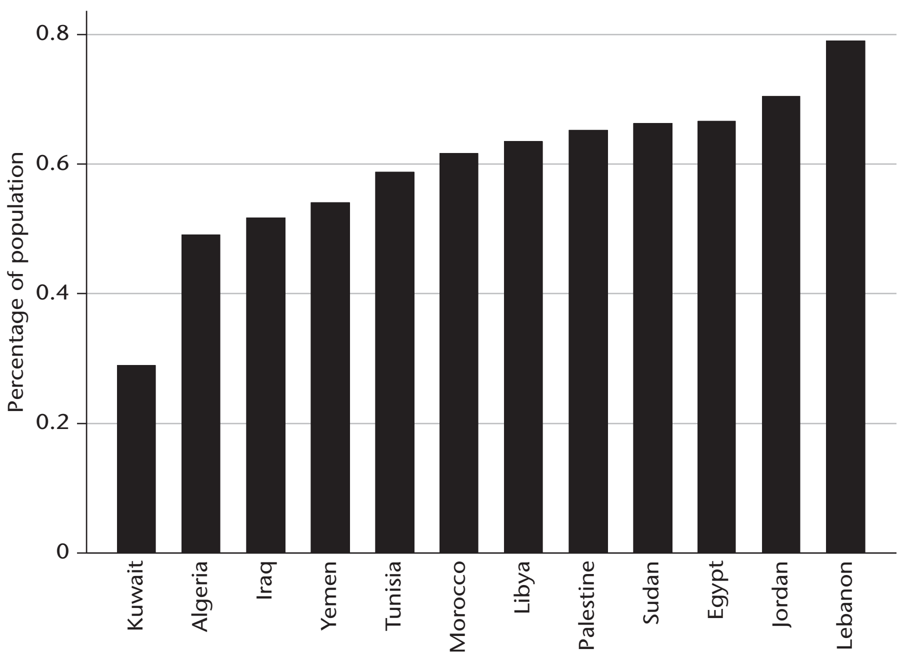


Figure 4.5. Share of population that believes jobs are obtained on the basis of *wasta*. This figure shows the share of people who answered 1 to the question: Some people say that nowadays it is impossible to get a job without connections (*wasta*), while others say that jobs are only available to qualified candidates. Based on a recent experience (or experiences) you are personally aware of, do you think that: 1. Obtaining employment through connections is extremely widespread. 2. Employment is sometimes obtained through connections. 3. Employment is mostly obtained without connections. 4. I do not know of any relevant experiences. 5. I do not know examples concerned.

Source: Arab Barometer wave 4, 2014

PCFs and non-PCFs differently. More competition by other PCFs reduces their net job creation and *increases* their output per worker. The presence of more PCFs in a sector also reduces hiring by non-PCFs, but their productivity is not affected. These findings suggest that more competitive pressures by PCFs reduce the value of their privileges, limiting their ability to pay-back politicians with jobs.

In sum, comparing the performance of PCFs and non-PCFs in connected sectors allows us to obtain findings that constitute a solid basis for claiming causality between connectedness and job creation, as per H3—that PCFs are pushed to overhire by politicians as a repayment for the favors they bestow on them. The results also enrich our priors. Political connections confer advantages to PCFs, but these rents are partially dissipated through greater hiring and higher wages. Increased competition by PCFs reduces these rents and the extent of payback in clientelistic favors. On the other hand, non-PCFs shrink as PCFs expand. But, so far, we have not measured the net effect of political connections on a sector. On a net basis, do the privileges received by PCFs result in more jobs (because of their effect on PCFs) or fewer jobs (because of the negative reaction by non-PCFs)? To measure the net effect of political connections on job creation, we conducted in Diwan and Haidar (2017) a cross-sector analysis to learn whether sectors with more PCFs tend to hire less.

4.5 Do Connected Sectors Grow and Hire Less?

We now address the second broad hypothesis that asserts that the presence of PCFs in a sector decreases sectoral performance in Lebanon. The hypothesis is that while PCFs contributed directly to employment growth, their dominance in their sector of operation had negative impact on job creation by their competitors, and this effect was so large as to dominate at the sector level.

We cannot observe a counterfactual of firm dynamics in the absence of PCFs in particular sectors, since our time series is not long enough to observe the entry of PCFs in previously unconnected sectors. So, we will have to resort to comparing dynamics in sectors that are otherwise *similar*, but differ only in the intensity of their political connections. Assuming we find that political connections are strongly associated with reduced job creation, the problem of identifying the underlying cause of this underperformance remains a complicated task. There are three hypotheses that can explain this result in a coherent way:

- First, our preferred interpretation is along the Aghion et al. (2001) competition argument (call this H4). In industries that exhibit monopolistic competition, competing firms have incentives to pursue productivity

growth only when they have comparable cost structures. When leading firms in their sector have large cost advantages that cannot be overcome by trailing firms, the market leaders have little incentive to invest in innovation. At the same time, the laggard firms are too far away from the frontier to bridge the cost gap. Instead, they use vintage production technologies, focusing on local market niches to survive. Thus, too little competition can hurt growth.[21] For this hypothesis to hold, we should observe lower job creation and lower output growth in connected sectors.

- Second, an all-together different hypothesis, which is coherent with the facts shown above, is that there is an endogenous selection of PCFs into sectors with specific characteristics, and, in particular, into rent-filled sectors, which may also have low growth opportunities. In this case, PCFs would not cause low growth in the sectors they enter; they simply prefer to enter into low-growth sectors.[22] Let us term this hypothesis H5. For this hypothesis to hold, we should observe higher job creation but lower output growth in connected sectors.
- A third possibility is that because PCFs are likely to be capital intensive, when they expand, sector output expands, but jobs can disappear at the sector level because machines substitute for jobs (H6). For this hypothesis to hold, we should observe lower job creation but higher output growth in connected sectors.

Since we cannot see other coherent explanations, we thus need to test whether sector dynamics are consistent with H4 but contradict H5 and H6. In making these comparisons, we will have to be careful and control for a large set of sector characteristics, so as to be able to claim that we are comparing sectors with and without PCFs that would otherwise tend to show similar (residual) characteristics. The impact of the number of PCFs on the connected sectors' relative performance provides an extra test, as only in H4 would this lead to a deterioration of the connected sectors. Finally, the election event provides an additional test. If connected sectors deteriorate more during election years, then H4 but not H5 and H6 would be supported, since the sectors without PCFs cannot become less growth friendly only around elections.

Comparing sectors is a much less precise endeavor than comparing firms, since the number of sectors with political connections is relatively small

[21] Aghion et al. (2001) showed that while perfect competition can reduce the incentives for innovation by reducing the discounted present value of rents from innovations (*rent-dissipation effect*), too little competition has the same effect.
[22] A related argument is that that rent-filled sectors may be naturally less competitive, for example because of high entry costs, and thus have lower entry and exit rates.

relative to the total number of sectors (289 at the 4-digit sector level).[23] Our main findings in Diwan and Haidar (2017) are that on average, connected sectors grow less, create fewer jobs, display lower output per worker, and pay higher wages than unconnected sectors. Moreover, all these characteristics worsen when the number of PCFs in the sector rises. We also find that all sectors grew less during the 2009 election year, but that connected sectors grew even less during 2009 than unconnected sectors.

These results support H4, but not H5 and H6. Not only do connected sectors grow less and create less jobs than unconnected sectors, but also growth is even lower the more PCFs operate in the sector (for every additional PCF in a sector, we find that 6.8 percent fewer jobs are created each year on average). Moreover, this impact increases to 9.4 percent in the year 2009. This evidence contradicts H5, since PCFs deteriorate even more during election years. H6 is also disproved since we find that connected sectors shrink in terms of both output and jobs.

This process of elimination thus makes H4 the most plausible explanation. Even though PCFs overhire, the negative incentives on innovation and investment created by unfair competition in the sector in which they operate lead to less job creation compared to unconnected sectors. The magnitude of the result can be compared to that of Egypt. Diwan et al. (2015) estimate that the entry of a PCF into a previously unconnected sector reduces employment growth in this sector by 15–25 percent. If there were more than three PCFs per sector it would appear that the adverse sector-level effect of cronyism on jobs is larger in Lebanon than in Egypt. However, as stated above, a larger share of sectors of activity includes PCFs in Egypt, and, as a result, the macro-economic cost of cronyism is likely to be larger in Egypt than in Lebanon.

4.6 Conclusions

Through the compilation of a unique dataset and rigorous empirical analysis in Diwan and Haidar (2017), this chapter highlights two important conclusions about the effect of cronyism on employment in Lebanon. First, PCFs are larger and create more jobs, but are also less productive and pay higher wages than non-PCFs in their sectors.

[23] The results of regression analysis in Diwan and Haidar (2017) are from a set-up where we regress sector performance (our dependent variables in different estimations are net job creation, average wage per employee, output, and output per employee at the sector-year level) on the number of PCFs at the sector-year level; and on an election dummy (equal to 1 in year 2009 and zero otherwise). We also controlled for exogenous sector characteristics, including average firms size (employment) and age of PCFs and of non-PCFs at the sector-year level. We restricted the analysis to all 4-digit sectors with at least 10 percent of the firms having at least 50 employees in at least one year between 2005 and 2010.

Second, PCFs reduce net job creation at the sector level by affecting growth of non-PCFs: For every additional PCF in a sector, 6.8 percent fewer jobs are created each year, on average. These results tend to confirm the prevalent popular perceptions about the negative economic impact of political "corruption" in Lebanon, contributing to formalizing the notion that PCFs are used for clientelistic purposes, exchanging privileges for jobs that benefit their patrons' supporters, but that this takes place at the cost of lower aggregate employment growth.

It is hard to draw simple policy implications from these results. At one level, it would seem that competition policies and a better enforcement of rules that could level the playing field would promote growth and job creation over time (compared to second-best policies, such as support for SME growth through subsidized credit, for example). At a deeper level, however, a more competitive economic structure would endanger the current oligarchic political equilibrium, which could possibly lead to political chaos in the absence of an alternative political settlement. Nevertheless, a better understanding of the nexus between power and money can only put informed citizen groups in a better position to influence changes that can improve the overall economic and political environment.

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